

shall be included in the employee's gross income for such taxable year, to the extent provided in paragraph (b) of this section. However, the preceding sentence does not apply to an annuity contract purchased and held as part of a plan that at the time of such purchase and at all times thereafter meets the requirements of section 404(a)(2). For purposes of this section, the value of an annuity contract on the date the employee's rights change from forfeitable to nonforfeitable rights means the cash surrender value of such contract on such date. As to what constitutes nonforfeitable rights of an employee, see § 1.402(b)-1(d)(2). For the rules with respect to amounts paid after August 1, 1969, under an annuity contract purchased for an employee by an employer which is exempt from tax under section 501(a) or 521(a), see generally section 403(c) and the regulations thereunder.

(b) *Extent to which value of annuity contract is includible in employee's gross income.* For purposes of paragraph (a) of this section, there shall be included in the gross income of an employee for his taxable year in which his rights under an annuity contract change from forfeitable to nonforfeitable rights only an amount equal to the portion of the value of such contract on the date of such change (1) that is attributable to contributions:

(i) Which were made by the employer while it was exempt from tax under section 501(a) or 521(a);

(ii) Which were made after December 31, 1957; and

(iii) Which were not, at the time they were made, excludable from the employee's gross income under paragraph (a) of § 1.403(b)-1;

and (2) that is not excludable from the employee's gross income under paragraph (b) of § 1.403(b)-1. Thus, although amounts are contributed by an employer after December 31, 1957, toward the purchase for an employee of an annuity contract and, at the time of the contribution, such employer is an organization described in section 501(c)(3) and exempt from tax under section 501(a), the value of such annuity contract attributable to such contributions would not be includible in the employee's gross income for the taxable year in which his rights under the

contract change to nonforfeitable rights if such amounts were contributed during a taxable year of the employee beginning before January 1, 1958, and were, therefore, excludable from the employee's gross income under paragraph (a) of § 1.403(b)-1. Similarly, the value of such an annuity contract is not includible in the gross income of the employee for the year in which the change occurs to the extent that it is excludable under paragraph (b) of § 1.403(b)-1. See paragraph (b)(2) of § 1.403(b)-1 which provides that the amount otherwise includible in gross income under section 403(d) is considered to be a contribution by the employer for purposes of the exclusion provided in paragraph (b) of § 1.403(b)-1. In addition, the portion of the value of an annuity contract attributable to contributions made by the employer while it was not exempt from tax under either section 501(a) or 521(a) is not includible in the gross income of the employee at the time his rights under the contract change to nonforfeitable rights even though the employer is exempt from tax under section 501(a) or 521(a) at the time of such change. On the other hand, the value of the annuity contract purchased by an organization exempt from tax under section 501(a) or 521(a) may be includible in the gross income of an employee for the year during which his rights under the contract change to nonforfeitable rights even though such organization is not exempt on the date of such change.

(c) *Partial vesting*—(1) *General rule.* If, during any taxable year of an employee, only part of his beneficial interest in an annuity contract changes from a forfeitable to a nonforfeitable interest, then only the corresponding part of the value of the annuity contract on the date of such change is includible in the employee's gross income for such taxable year. In such a case, it is first necessary to compute, under the rules in paragraphs (a) and (b) of this section but without regard to any exclusion allowable under paragraph (b) of § 1.403(b)-1, the amount which would be includible in the employee's gross income for the taxable year if his entire beneficial interest in the annuity contract had changed to a nonforfeitable interest during such

§ 1.404(a)-1

26 CFR Ch. I (4-1-03 Edition)

year. The amount that is includible (without regard to any exclusion allowed by paragraph (b) of § 1.403(b)-1) in the gross income of the employee for the taxable year in which the change occurs is an amount equal to the amount determined under the preceding sentence multiplied by the percent of the employee's beneficial interest which changed to a nonforfeitable interest during the taxable year. If at the time the employee's interest changes to a nonforfeitable interest, the employer is an organization described in section 501(a)(3) and exempt from tax under section 501(a), then the amount that is includible in the employee's gross income under this subparagraph is considered as an employer contribution to which the exclusion provided in paragraph (b) of § 1.403(b)-1 applies (see paragraph (b)(2) of § 1.403(b)-1).

(2) *Example.* The provisions in paragraph (c)(1) of this section may be illustrated by the following example:

Example. X organization purchased an annuity contract for A, one of its employees who reports his income on a calendar year basis. X contributed $\frac{1}{3}$ of of amount necessary to purchase the contract before January 1, 1958, and the remaining $\frac{2}{3}$ after December 31, 1957. At the time of the contributions, X was an organization exempt from tax under section 501(a) and A's rights under the contract were forfeitable. The annuity contract was not purchased as part of a qualified plan and A made no contributions toward the purchase of the contract. On December 31, 1965, 50 percent of A's interest in the contract changed from a forfeitable to a nonforfeitable interest, and on December 31, 1968, the remaining 50 percent of A's interest in the contract changed to a nonforfeitable interest. The cash surrender value of the contract was \$9,900 on December 31, 1965, and \$12,000 on December 31, 1968. The amount includible in A's gross income for 1965 and 1968 is computed as follows—

1965

(i) Amount which would have been includible if A's entire interest had changed to a nonforfeitable interest (cash surrender value of contract on December 31, 1965, attributable to contributions made after December 31, 1957), $\frac{2}{3} \times \$9,900$, \$6,600.

(ii) Percent of A's interest that changed to a nonforfeitable interest on December 31, 1965, 50 percent.

(iii) Amount includible in A's gross income for 1965 ((ii)×(i)), \$3,300.

1968

(iv) Amount which would have been includible if A's entire interest had changed to a nonforfeitable interest (cash surrender value of contract on December 31, 1968, attributable to contributions made after December 31, 1957), $\frac{2}{3} \times \$12,000$, \$8,000.

(v) Percent of A's interest that changed to a nonforfeitable interest on December 31, 1968, 50 percent.

(vi) Amount includible in A's gross income for 1968 ((v)×(iv)), \$4,500.

If, on December 31, 1965, X is an organization described in section 501(c)(3) and exempt from tax under section 501(a), then only so much of the \$3,300 as is not excludable under paragraph (b) of § 1.403(b)-1 is includible in A's gross income for 1965. Similarly, if, on December 31, 1968, X is an organization described in section 501(c)(3) and exempt from tax under section 501(a), then only so much of the \$4,500 as is not excludable under paragraph (b) of § 1.403(b)-1 is includible in A's gross income for 1968.

(Secs. 83 and 7805 of the Internal Revenue Code of 1954 (83 Stat. 588; 68A Stat. 917; 26 U.S.C. 83 and 7805))

[T.D. 6783, 29 FR 18365, Dec. 24, 1964, as amended by T.D. 7554, 43 FR 31925, July 24, 1978]

§ 1.404(a)-1 Contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan; general rule.

(a)(1) Section 404(a) prescribes limitations upon deductions for amounts contributed by an employer under a pension, annuity, stock bonus, or profit-sharing plan, or under any plan of deferred compensation. It is immaterial whether the plan covers present employees only, or present and former employees, or only former employees. Section 404(a) also governs the deductibility of unfunded pensions and death benefits paid directly to former employees or their beneficiaries (see § 1.404(a)-12). For taxable years beginning after 1962, certain self-employed individuals may be covered by pension, annuity, or profit-sharing plans. For the rules relating to the deduction of contributions on behalf of such individuals, see paragraph (a)(2) of § 1.404(a)-8 and § 1.404(e)-1.

(2) Section 404(a) does not apply to a plan which does not defer the receipt of compensation. Furthermore, section 404(a) does not apply to deductions for